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No. 88-1003

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether income received by a financial institution from its depositors as penalties for early withdrawal is excludable from gross income as income from "the discharge * * * of indebtedness," within the meaning of Section 108 of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A25) is reported at 854 F.2d 1001. The opinion of the Tax Court (Pet. App. A25-A46) is reported at 85 T.C. 855.

JURISDICTION

The judgment of the court of appeals (Pet. App. A26-A27) was entered on August 10, 1988. A petition for rehearing was denied on September 13, 1988 (Pet. App. A50). The petition for a writ of certiorari was filed on December 12, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner Colonial Savings Association is a Wisconsin savings and loan association.[1] During its taxable year ended June 30, 1980, petitioner had outstanding various types of savings accounts with differing terms. Interest on these accounts was computed and added to the depositors' accounts on a daily basis. A depositor was free at any time to withdraw the principal balance in his savings account, plus the interest earned through that day. Some of petitioner's accounts, commonly known as "certificates," guaranteed a fixed interest rate for a specified term of years. Federal regulations required depositors to pay a penalty to petitioner if they withdrew the principal balance of such certificates prior to maturity. See 12 C.F.R. 526.7 (1980); 12 C.F.R. 526.7 (1979) (*reprinted in* Pet. App. A4 n.3). Under the terms of the account agreements, this early withdrawal penalty was paid by reducing the amount payable to the depositor. Pet. App. A3-A4, A30-A33.

During the tax year in issue, petitioner received $600,745 in early withdrawal penalties (Pet. App. A33). Petitioner treated the penalties as income from the discharge of indebtedness that was excluded from gross income under Section 108 of the Internal Revenue Code.[2]

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[1] For convenience, we will use the term "petitioner" to refer to petitioner Colonial Savings Association.

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the taxable year in issue. Section 108 generally provided that no amount is included in gross income by reason of the discharge of indebtedness if the taxpayer made an election under Section 1017 of the Code to reduce the basis of other property. Petitioner made the necessary election (Pet. App. A33). Section 108 was amended in 1986 to limit its application to cases where the taxpayer is insolvent or the discharge occurs in a bankruptcy case, but that amendment is not applicable to the years at issue here. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2373 § 822(a); Pet. App. A8 n.5.

The Commissioner determined that the penalties did not constitute income by reason of the discharge of indebtedness within the meaning of Section 108 and therefore had to be included in petitioner's gross income. Petitioner sought redetermination of the resulting deficiency in the Tax Court. Pet. App. A3, A33.

2. The Tax Court held that the early withdrawal penalties did not constitute income from the discharge of indebtedness (Pet. App. A28-A46). The court observed that a debtor does not have income from the discharge of indebtedness "if the debt forgiveness is simply the method by which a creditor makes a payment to a debtor" (Pet. App. A42). The court concluded that "[t]he penalty or forfeiture was an obligation of the depositor, which petitioner and [the] depositor agreed, in advance, could be satisfied from interest credited or principal deposited in the account" (*id.* at A44). Since the indebtedness "was essentially used to pay the penalty" (*id.* at A45), the debt was satisfied, not discharged, and Section 108 was inapplicable.

The court of appeals unanimously affirmed (Pet. App. A1-A25). The court observed that "when the discharge of indebtedness is a mere medium for the payment of a separate obligation between two parties, section 108 does not apply" (*id.* at A9). Rejecting petitioners' contention to the contrary, the court of appeals' analysis of the nature of early withdrawal penalties led it to conclude that they "represent separate obligations from depositors to [petitioner]" (*id.* at A13). The purpose of the penalty, the court observed, is "to compensate the bank-debtor for the harm" caused by the depositor's withdrawal of the funds prior to the agreed term; the penalty "is a form of liquidated damages for the added expense that the bank must suffer in an effort to procure the funds that have been lost" (*id.* at A11). Although the income produced by the penalty arose out of a debtor-creditor relationship, the

court concluded that the income "did not arise 'by reason of the discharge of indebtedness.' Rather, it arose by reason of the creditor's alteration of the parties' contract and the consequential expenses of the bank/debtor" (*id.* at A11-A12). The court also noted that the special action taken by Congress with respect to the tax treatment of a depositor who pays an early withdrawal penalty indicated its view that the depositor's obligation to pay the penalty is separate from the financial institution's obligation to repay principal plus interest (*id.* at A12-A13).

ARGUMENT

Petitioners contend that the amount of the early withdrawal penalties paid by its depositors was income realized from the discharge of indebtedness within the meaning of Section 108 of the Code. This contention was correctly rejected by both courts below. Moreover, the decision below does not conflict with any decision of another court of appeals or of this Court.[3] Accordingly, there is no reason for further review.

Petitioners do not dispute that the early withdrawal penalties in issue are income. The question presented is whether they are a particular type of income that qualifies for special treatment under Section 108 of the Code. That section generally provides that income realized "by reason of the discharge * * * of indebtedness" may be excluded

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[3] There is no merit to petitioners' suggestion (Pet. 8-10) that this case should be held because the same issue is pending in another case on the government's appeal in the Fifth Circuit. See *Centeni ial Savings Bank FSB* v. *United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), appeal pending, (No. 88-1297). There is no reason to anticipate that the Fifth Circuit will disagree with the decisions of the Tax Court and the Seventh Circuit here. If a conflict in the circuits ever does develop on the question presented here, the Court can consider at that time whether certiorari is appropriate in those circumstances.

from gross income if the taxpayer elects under Section 1017 to reduce its basis in property it owns in an amount equal to the amount excluded. The effect of these provisions is to permit deferral of the tax on the debt discharge income; the tax is ultimately collected indirectly because the taxpayer must take lower depreciation deductions for the reduced-basis assets or recognize greater gains on their sale. As the court of appeals observed (Pet. App. A7-A8), the purpose of Section 108 was to grant relief from immediate taxation to taxpayers who strengthen their financial position on paper through debt reduction. The legislative history of Section 108 indicates that Congress was responding to the concern that current taxation of the resulting income might discourage a debtor from reducing its debt, because the transaction did not produce assets that could be used to pay the tax. S. Rep. No. 1631, 77th Cong., 2d Sess. 45-46, 77-78 (1942); H.R. Rep. No. 855, 76th Cong., 1st Sess. 5 (1939); 97 Cong. Rec. 3796 (1951) (statement of Rep. Camp).

It is well established that a taxpayer can realize income from the discharge of a debt when the debt is forgiven, cancelled, or otherwise discharged for less than its face amount. See *Commissioner* v. *Jacobson,* 336 U.S. 28, 38-40 (1949); *United States* v. *Kirby Lumber Co.,* 284 U.S. 1 (1931). But not every debt that is cancelled or discharged results in income "by reason of the discharge" of the debt within the meaning of Section 108. If the cancellation of a debt is not, in and of itself, the source of the income, but simply the method by which a creditor makes a payment to a debtor, then the debtor does not have income "by reason of" a debt discharge; he has income "by reason of" receiving a payment. Such income does not qualify for the Section 108 exclusion. See *OKC Corp.* v. *Commissioner,* 82 T.C. 638, 647-649 (1984); S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980). The Tax Court (Pet. App.

A42-A46) and the court of appeals (*id.* at A9-A13) correctly held that the income received by petitioner from the early withdrawal penalties paid by its depositors is governed by this principle.

Federal regulations require a depositor to pay a penalty to petitioner in order to withdraw the principal from one of petitioner's fixed-term accounts prior to maturity. Petitioner collects these penalties for early withdrawal by reducing the amount otherwise payable to the depositor. If instead the depositor had paid the penalty to petitioner in cash and in turn received the entire amount due on the certificate, petitioner would have had income in the amount of the penalty and that income clearly would not have been income from the discharge of indebtedness. The result should be no different where, as here, the method of paying the penalty is by reducing the amount turned over to the depositor. Petitioner did not have income "by reason of" the discharge of indebtedness; it had income "by reason of" receiving a penalty.

Income from the discharge of indebtedness is realized where a debt is discharged for less than its face amount, *i.e.*, where all or a portion of the debt is forgiven. Here, although the debt owed to a depositor was "discharged" in the sense that it was extinguished, it was not discharged for less than face value. The portion of the debt that petitioner did not pay to the depositor was not forgiven by the depositor, but rather was used to satisfy—*i.e.*, to pay—the penalty obligation owed by the depositor. As the court of appeals concluded, "early withdrawal penalties represent separate obligations from depositors to [petitioner]" (Pet. App. A13), and therefore they are not encompassed within Section 108 of the Code.

Petitioners' objections to the court of appeals' analysis are unavailing. First, their assertion (Pet. 12-13) that the instant case is indistinguishable from *United States* v.

Kirby Lumber Co., supra, is mistaken. In *Kirby Lumber,* the taxpayer issued bonds for which it received their par value. The bonds declined in value, and the taxpayer later purchased some of the bonds on the open market at less than par value. This Court held that the taxpayer had realized income from the discharge of indebtedness. See 284 U.S. at 3. The transaction involved in *Kirby Lumber* is quite unlike the transaction here. The bondholders in *Kirby Lumber* had no separate obligation to the taxpayer, nor did they receive anything in exchange for the discharged debt. Here, by contrast, the savings certificate agreement and federal regulations imposed a fixed obligation on the depositors, and that obligation was satisfied by the reduction of the amount paid to them on their certificates. Petitioners' reliance (Pet. 13 n.9) on *Columbia Gas System, Inc.* v. *United States,* 473 F.2d 1244 (2d Cir. 1973), is misplaced for the same reason. In *Columbia Gas,* some of the taxpayer's convertible bonds were converted into stock, and the penalty for that conversion under the terms of the bonds was forfeiting the accrued interest on the bonds. The bondholders had no separate obligation to the taxpayer and did not receive anything in exchange for the discharged interest debt.

More generally, petitioners contend (Pet. 11-12) that the income here must be encompassed within Section 108 because the penalty was not a "separate and distinct" obligation of the depositor to petitioner. But the fact that the penalty obligation arose under a provision of the savings certificate agreement (which was required by federal regulations)—*i.e.,* the fact that there was only one *contract* between petitioner and an individual depositor—does not mean that there was only one *obligation* between petitioner and that depositor. Petitioner owed the depositor money as part of the traditional relationship between a debtor-bank and creditor-customer. With respect to the

penalty, on the other hand, the depositor was the debtor owing money to petitioner. The depositor's obligation to pay the penalty was a separate aspect of the parties' relationship.

The court of appeals also was correct in noting (Pet. App. A12-A13) that the specific actions taken by Congress in connection with early withdrawal penalties, and its failure to take any action to provide financial institutions with the income tax treatment that petitioner seeks, support the conclusion that income from early withdrawal penalties is not covered by Section 108. In Rev. Rul. 73-511, 1973-2 C.B. 402, the Commissioner ruled that a depositor who pays an early withdrawal penalty out of interest earned on the account may not reduce his interest income by the amount of the penalty, but rather must report the full amount of interest earned on the account; he may then deduct the amount of the penalty as a loss under Section 165 of the Code. The ruling was based on the rationale that the interest and the penalty represent separate transactions. The ruling further concluded that the loss would, in the case of an individual depositor, generally be considered as a loss "incurred in any transaction entered into for profit, though not connected with a trade or business," as described in Section 165(c)(2). One of the consequences of this determination was that the loss could be claimed as a deduction only by a taxpayer who itemizes deductions.

Congress was troubled by the proposition that taxpayers who used the standard deduction could not deduct their early withdrawal penalties. Accordingly, it amended the Code to provide that the deduction for early withdrawal penalties would be allowable in arriving at adjusted gross income, thus allowing non-itemizers to claim the deduction as well. See Sec. 6(a) of the Act of Oct. 26, 1974, Pub. L. No. 93-483, 88 Stat. 1458-1459 (current version codi-

fied at 26 U.S.C. § 62(a)(9) (Supp. IV 1986)). Congress did not, however, disapprove the Commissioner's conclusion that interest and early withdrawal penalties are separate and distinct obligations; to the contrary, the legislative history of the amendment clearly supports that position. See H.R. Conf. Rep. No. 1405, 93d Cong., 2d Sess. 5 (1974); 120 Cong. Rec. 28117 (1974) (statement of Sen. Church). Indeed, the Conference Report describes Rev. Rul. 73-511 as embodying "present law" (H.R. Conf. Rep. No. 1405, at 5), and the amendment did not change the law with regard to the treatment of interest and penalties as separate obligations.

Petitioners complain (Pet. 16) that the court of appeals relied too heavily on "Congressional 'silence' " with respect to the tax treatment of financial institutions that receive early withdrawal penalties. But the court of appeals primarily relied not on "silence" but on Congress's considered response to Rev. Rul. 73-511.[4] And the court invoked this congressional action merely to confirm its correct conclusion that the penalty is a separate obligation—a conclusion that was independently based on the nature of the penalty (see Pet. App. A9-A12). Since that penalty obligation is separate from the financial institution's obligation to the depositor on the savings certificate, petitioner's receipt of the penalties did not amount to income "by reason of the discharge * * * of indebtedness."

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[4] Petitioners also place undue reliance (Pet. 15-16) on the fact that Rev. Rul. 73-511 discussed a situation in which the depositor paid the penalty out of interest. Nothing in the ruling, or in the nature of the penalty, suggests that the result would be different where the penalty is paid in part out of principal.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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